

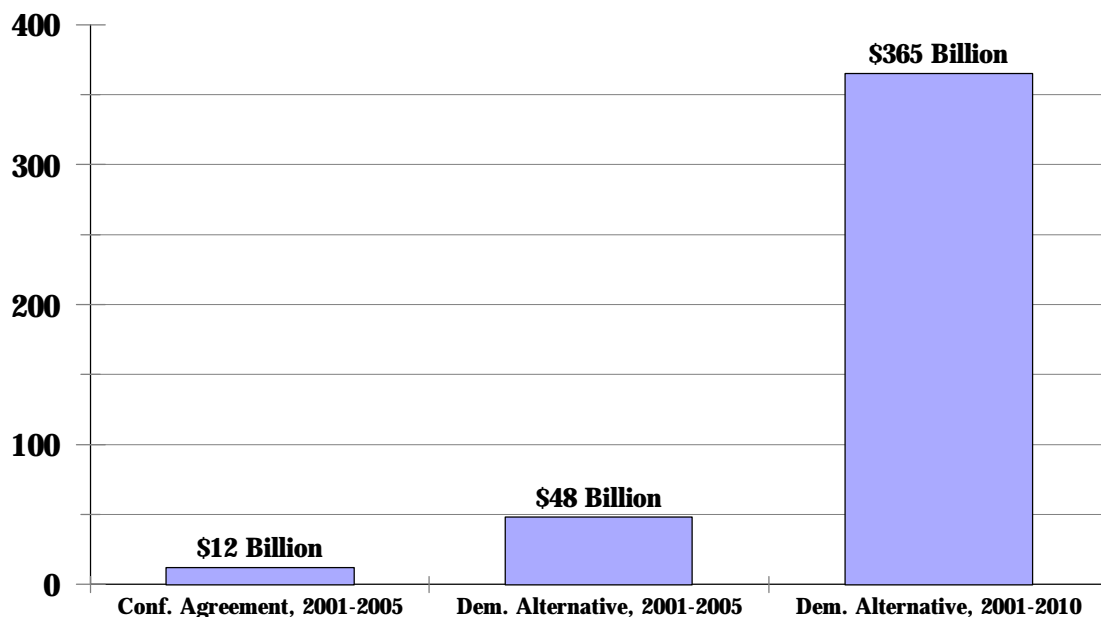
Debt Reduction

The conference agreement on the Republican budget resolution provides that virtually none of the non-Social Security, or on-budget, surplus is used to retire publicly held debt. Over the first five years, the conference agreement devotes only \$12 billion, or 8 percent, of the on-budget surplus to debt reduction. After 2005, if appropriations increase at the same pace as assumed for the first five years and the tax cut grows somewhat more slowly than the tax cut bill Congress passed last year, the Social Security surplus begins to be spent starting in 2008.

The above calculations take at face value the conference agreement's unrealistic cuts to real purchasing power for non-defense appropriations. If these cuts do not occur, on-budget deficits appear even sooner, and some of the Social Security surplus is used to fund other government functions rather than pay down debt. It is not plausible to believe that Congress, which has increased funding for non-defense programs faster than inflation over the last four years, will now turn on a dime and start imposing large cuts in non-defense programs. Large projected surpluses make these cuts even harder, especially since the conference agreement jettisons important budget enforcement mechanisms like spending caps and pay-as-you-go rules.

The Democratic alternative budget, which did not receive a single Republican vote in the House, took a more aggressive and fiscally responsible approach to debt reduction. It called for devoting \$365 billion over 10 years, or 41 percent, of the on-budget surplus to debt reduction and completely extinguishing the publicly held debt by 2013. The President's budget contained a similar proposal. Furthermore, these projections were not based on unrealistic assumptions about sharp cuts in the real purchasing power of non-defense programs.

Portion of On-Budget Surplus Devoted to Debt Reduction



The Economic Benefits of Paying Off Publicly Held Debt

Most economists, including Federal Reserve Alan Chairman Greenspan, argue that paying down debt held by the public provides significant benefits to the economy. This is why the Fed Chairman has repeatedly testified to the Congress that debt reduction at this time should be the nation's highest priority for fiscal policy. For instance, in January he told the Senate Banking Committee:

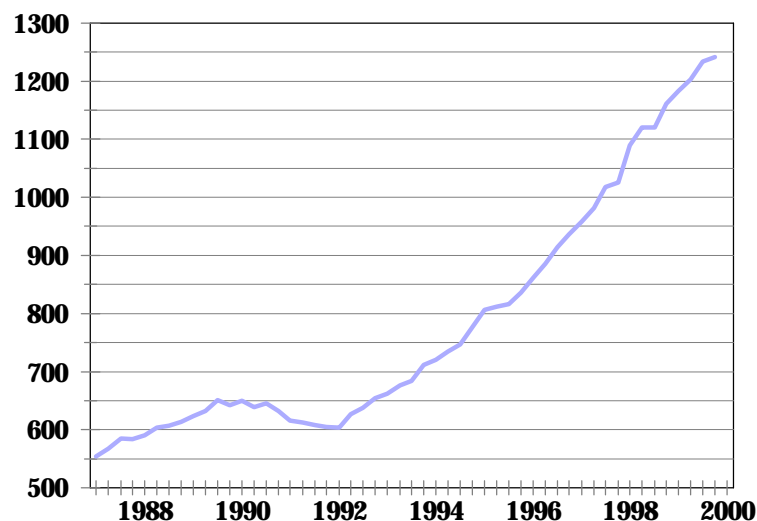
“...I’ve said previously to this committee, because of the nature of the type of acceleration in productivity and dynamic change that is occurring in the American economy, my first priority would be to allow as much of the surplus to flow through into a reduction in debt to the public. In my judgment, that would be, from an economic point of view — and I recognize there are other priorities, obviously — from an economic point of view, that would be by far the best means of employing it.”

As noted by Chairman Greenspan, withdrawing the federal government's demand for credit from financial markets means that more is available for the private sector. This lowers interest rates and boosts business investment in new plant and equipment. Newer, better equipment in turn boosts workers' productivity. Productivity is the wellspring of rising living standards because it means that the economy and workers' incomes can grow rapidly without igniting inflation.

In the last several years, we have seen dramatic confirmation of economists' reasoning about fiscal discipline and its economic benefits. Real (i.e. inflation-adjusted) business investment has surged at more than a ten percent annual rate over the last five years. This constitutes the strongest sustained expansion in new plant and equipment on record. As a consequence, labor productivity over the last four years has grown at a 2.8 percent average rate. This is the strongest four-year advance in productivity since the economy was recovering from the very deep 1982 recession when unemployment peaked at 10.8 percent. Before that, productivity had not grown this fast since the 1960s.

Real Business Fixed Investment

Billions of 1996 Dollars



Strong productivity growth has supported strong growth in real income. The value of wages, salaries, and benefits after adjusting for inflation has risen at a 2.1 percent annual rate over the last four years, the best pace in over 25 years. This strong income growth has not come at the expense of inflation because the associated productivity gains have held down unit labor costs, which account for about 70 percent of total production costs. In fact, unit labor costs actually have *declined* over the last two quarters.

There is broad agreement that the fiscal discipline that turned persistent deficits into current surpluses and projections of substantial future surpluses has played a crucial role in making the current economic expansion vigorous and long-lived. The economy is now entering its 110th month of expansion, making it the longest upswing in our nation's history. Jobs are plentiful, inflation remains quiescent, and real incomes are rising. We now have the opportunity to pay off the debt that so burdened the economy in the 1980s without asking the citizens to sacrifice in order to accomplish it.

Preparing for the Retirement of the Baby Boom Generation

In addition to the current economic benefits of continuing on the path of debt reduction, it is crucial that the federal government do its utmost to strengthen its finances over the next decade. Shortly after 2010, the Baby Boom generation will begin to retire, boosting expenditures for Social Security and Medicare. As Federal Reserve Chairman Greenspan and other economists have stressed, paying off the publicly held debt is a powerful, though indirect, means of preparing for the fiscal challenges that this demographic wave will create.

One reason that debt reduction will help to prepare for the retirement of the Baby Boom generation already has been discussed above. Because debt reduction promotes new investment and faster productivity growth, it creates a larger future economy. This means that the economic burden of caring for a large dependent population in the future can be borne more easily. Irrespective of how Social Security and Medicare are made solvent, having a larger economic "pie" in the future means that the working population will have higher real incomes to enjoy at the same time that society is providing for the non-working elderly.

In addition, paying off publicly held debt will strengthen the federal government's finances as it prepares for the fiscal burdens that will arise after 2010. This is the logic behind the Social Security and Medicare proposals in both the President's budget and the Democratic alternative budget. Paying down the debt will reduce the associated annual interest burden. In 1999, interest on the publicly held debt was the third largest spending item in the budget, totaling \$230 billion for just that one year. Removing this annual expense from the government's books would create far more latitude to address the budget pressures associated with the retirement of the Baby Boom generation. (For further discussion, see *Social Security and Medicare Solvency*.)